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Governmental Accounting Standards Series

GASB Technical Bulletin No. 2003-1

Title: Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets

References: NCGA Statement 1, *Governmental Accounting and Financial Reporting Principles*
NCGA Interpretation 6, *Notes to the Financial Statements Disclosure*
GASB Statement No. 1, *Authoritative Status of NCGA Pronouncements and AICPA Industry Audit Guide*
GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*
GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*
GASB Statement No. 38, *Certain Financial Statement Note Disclosures*
GASB Statement No. 40, *Deposit and Investment Risk Disclosures*
GASB Technical Bulletin No. 94-1, *Disclosures about Derivatives and Similar Debt and Investment Transactions*
FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* as amended
FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*

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CONTENTS

Introduction

1. This Technical Bulletin supersedes Technical Bulletin 94-1 (TB 94-1) and clarifies guidance on derivative disclosures, pending the results of the GASB's project on reporting and measurement of derivatives and hedging activities. This Technical Bulletin applies to derivatives that are not reported at fair value on the statement of net assets. It provides an updated definition of derivatives; it also provides disclosure requirements for the government's objective for entering into the derivative and the derivative's terms, fair value, and risk exposures. These disclosure requirements are intended to provide information to financial statement users that will enhance their understanding of the significance of derivatives to a government's net assets and will assist them in assessing the amounts, timing, and uncertainty of future cash flows.

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Question 1

Definition

2. What is a derivative?

Response

3. Since the release of TB 94-1, the financial instruments environment has changed. In keeping with those changes, the definition from FASB Statement 133, paragraph 6, as amended, should be used to define a derivative. The basic definition is as follows:

> 6. A derivative instrument is a financial instrument or other contract with all three of the following characteristics:
>
> a. It has (1) one or more **underlyings** and (2) one or more **notional amounts**[3] or payment provisions or both. Those terms determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required.[4]
> b. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
> c. Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.
>
> Notwithstanding the above characteristics, loan commitments that relate to the origination of mortgage loans that will be held for sale, as discussed in paragraph 21 of FASB Statement No. 65, *Accounting for Mortgage Banking Activities* (as amended), shall be accounted for

[3]Sometimes other names are used. For example, the notional amount is called a face amount in some contracts.

[4]The terms *underlying, notional amount, payments provision,* and *settlement* are intended to include the plural forms in the remainder of this Statement. Including both the singular and plural forms used in this paragraph is more accurate but much more awkward and impairs the readability.

> as derivative instruments by the issuer of the loan commitment (that is, the potential lender). Paragraph 10(i) provides a scope exception for the accounting for loan commitments by issuers of certain commitments to originate loans and all holders of commitments to originate loans (that is, the potential borrowers).

This definition is further clarified in FASB Statement 133, paragraphs 7 through 9, as amended. Furthermore, the derivatives that pursuant to paragraph 10 of that Statement, as amended, are excluded from being subject to FASB Statement 133 are also excluded from the scope of this Technical Bulletin.

Question 2

Derivative Disclosures

4. What financial statement note disclosures should be presented for derivatives that are not reported at fair value on the statement of net assets?[1]

Response

5. Governments that, as of the date of the financial statements, are party to a derivative that was not reported at fair value on the statement of net assets should disclose the information described in paragraphs 6 through 10. Disclosure information for similar derivative types may be aggregated.

6. *Objective of the derivative*—The government should disclose its objective for entering into the derivative, the context needed to understand that objective, and its strategies for achieving the objective, indicating the types of derivatives used including options purchased or sold.

7. *Significant terms*—The government should disclose the significant terms of the transaction, including:

a. Notional, face, or contract amount
b. Underlying indexes or interest rates, including terms such as caps, floors, or collars
c. Options embedded in the derivatives
d. The date when the derivative became effective and when it is scheduled to terminate or mature
e. The amount of cash paid or received when the derivative was initiated.

[1] *Statement of net assets* also refers to *balance sheet.*

8. *Fair value*—The government should disclose the fair value of the derivative at the reporting date and, if that fair value is based on other than quoted market prices, the method and significant assumptions[2] used to estimate the fair value of the derivative. Acceptable methods are discussed in Question 3.

9. *Associated debt*—Some derivatives may be entered into with the intention of effectively making a government's debt obligation carry a synthetic interest rate. For example, a government may issue variable-rate debt and issue a pay-fixed, receive-variable interest rate swap with the objective of achieving a synthetic fixed rate for the combined instruments. If this is the case, the derivative's net cash flow should be disclosed in addition to the debt service requirements of the associated debt. Debt service requirements to maturity are required disclosures established by Statement 38, paragraphs 10 and 11.

10. *Risks*—The government should disclose, when applicable, its exposure to the following risks that could give rise to financial loss. Risk disclosures are limited to derivatives that are extant as of the date of the statement of net assets. Disclosures required by this paragraph may contain information that is also required by other paragraphs. However, these disclosures should be presented in the context of a derivative's risk.

a. *Credit risk* is the risk that a counterparty will not fulfill its obligations. If a derivative exposes a government to credit risk, the government should disclose that exposure as credit risk and also disclose the following information:
   (1) The credit quality ratings of counterparties as described by nationally recognized statistical rating organizations—rating agencies—as of the date of the statement of net assets. If a credit risk disclosure is required and the counterparty is not rated, the disclosure should indicate that fact.
   (2) The maximum amount of loss due to credit risk, based on the fair value of the derivative as of the date of the statement of net assets, that the government would incur if the parties to the derivative failed to perform according to the terms of the contract, without respect to any collateral or other security.
   (3) A brief description of the collateral or other security that supports derivatives subject to credit risk and information about the government's access to that collateral or other security.
   (4) Information about any master netting arrangements to mitigate credit risk. The disclosure should include a brief description of the terms of those arrangements.
   (5) The extent of diversification among counterparties.

[2]If a fair value is developed by a pricing service, there is no requirement to disclose significant assumptions if the pricing service considers those assumptions to be proprietary.

b. *Interest rate risk* is the risk that changes in interest rates will adversely affect the fair values of a government's financial instruments or a government's cash flows. If a derivative increases a government's exposure to interest rate risk, the government should disclose that increased exposure as interest rate risk and also the derivative's terms that increase such a risk. The determination of whether a derivative increases interest rate risk should be made after considering, for example, the effects of the derivative and any associated debt.
c. *Basis risk* is the risk that arises when variable interest rates on a derivative and an associated bond or other interest-paying financial instrument are based on different indexes. When relationships between different indexes vary and that variance adversely affects the government's calculated payments, cost savings or synthetic interest rates may not be realized. If a derivative exposes a government to basis risk, the government should disclose that exposure as basis risk and should also disclose the derivative's payment terms and any payment terms of the government's associated debt.
d. *Termination risk* is the risk that a derivative's unscheduled end will affect a government's asset/liability strategy or will present the government with potentially significant unscheduled termination payments to the counterparty. For example, a government may be relying on an interest rate swap to insulate it from the possibility of increasing interest rate payments. If the swap has an unscheduled termination, that benefit would not be available. If a derivative exposes a government to termination risk, the government should disclose that exposure as termination risk and also the following information, as applicable:
   (1) Any termination events that have occurred.
   (2) Dates that a derivative may be terminated.
   (3) Out-of-the-ordinary termination events contained in contractual documents, such as "additional termination events" contained in the Schedule to the International Swap Dealers Association Master Agreement.
e. *Rollover risk* is the risk that a derivative associated with a government's debt does not extend to the maturity of that debt. When the derivative terminates, the associated debt will no longer have the benefit of the derivative. An example is an interest rate swap that pays the government a variable-rate payment that is designed to match the term of the variable-rate interest payments on the government's bonds. If the derivative's term is ten years and the associated debt's term is thirty years, after ten years the government will lose the benefit of the swap payments. If a derivative exposes a government to rollover risk, the government should disclose that exposure as rollover risk and should also disclose the maturity of the derivative and the maturity of the associated debt.

f. *Market-access risk* is the risk that a government will not be able to enter credit markets or that credit will become more costly. For example, to complete a derivative's objective, an issuance of refunding bonds may be planned in the future. If at that time the government is unable to enter credit markets, expected cost savings may not be realized. If the derivative creates market-access risk, the government should disclose that exposure as market-access risk.

Question 3

Determination of Fair Value

11. What methods are acceptable for determining a derivative's fair value?

Response

12. GASB Statement 25, paragraph 24, provides:

> Fair value should be measured by the market price if there is an active market for the investment. . . . If a market price is not available, a forecast of expected cash flows may aid in estimating fair value, provided that the expected cash flows are discounted at a rate commensurate with the risk involved.

Within the context of discounted cash flows, formula-based methods such as zero-coupon and par-value methods are acceptable. The zero-coupon method calculates the future net settlement payments required—for example, by an interest rate swap—assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement on the swap. The par-value method compares, for example, the fixed rate on an interest rate swap with the current fixed rates that could be achieved in the marketplace should the swap be unwound. An option contained in a derivative may also be priced using an option pricing model, such as the Black–Scholes model, that considers probabilities, volatilities, time, underlying prices, and other variables.[3]

[3]Fair values developed by pricing services are acceptable, provided those values are developed using the methods described in paragraph 12.

Effective Date

13. The provisions of this Technical Bulletin are effective for financial statements for periods ending after June 15, 2003. Earlier application is encouraged.

The Governmental Accounting Standards Board has authorized its staff to prepare GASB Technical Bulletins to provide timely guidance on certain financial accounting and reporting problems, in accordance with the procedures described in Technical Bulletin No. 84-1, *Purpose and Scope of GASB Technical Bulletins and Procedures for Issuance*. The provisions of Technical Bulletins need not be applied to immaterial items.

The GASB has reviewed this Technical Bulletin and a majority of its members do not object to its issuance.

Appendix 1

BACKGROUND

Introduction

14. State and local governments use a wide range of derivatives with the objective of more effectively managing their debt and investments. However, derivatives also expose governments to possible significant risks. Research indicates that increasing numbers of governments are using derivatives with increasing notional amounts. Although the following list is not comprehensive, some common derivative transactions that generally are not reported at fair value on the statement of net assets are as follows:

a. An interest rate swap that is intended to effectively or synthetically convert variable-rate debt to fixed-rate debt.
b. An interest rate swap that is intended to effectively or synthetically convert fixed-rate debt to variable-rate debt.
c. A basis swap in which counterparties exchange payments based on the changes of two variable rates. For example, a basis swap could be constructed that calls for payments to the counterparty based on The Bond Market Association Municipal Swap Index™ (BMA) and the counterparty to make payments based on a percentage of the London Interbank Offered Rate (LIBOR).
d. An option on an interest rate swap—a swaption—that gives the purchaser the right but not the obligation to enter into an interest rate swap. The purchaser pays a premium to the issuer or writer.
e. An interest rate cap specifically purchased to give the purchaser protection against rising rates, or other indexes, above a given level.
f. A commodity swap that is intended to reduce a government's exposure to a commodity's price risk.
g. A contract that is intended to reduce a government's investment exposure to foreign currency changes.

Authoritative Basis for This Technical Bulletin

15. According to its rules of procedure, the GASB has authorized its staff to issue Technical Bulletins to provide guidance for applying GASB Statements and

Interpretations.[4] NCGA Statement 1, paragraph 158, and NCGA Interpretation 6, paragraph 6, indicate that notes to the financial statements should disclose significant items that, if omitted, would cause the financial statements to be misleading. (GASB Statement 1 adopts NCGA pronouncements as authoritative standards, unless changed by later GASB pronouncements.) NCGA Interpretation 6, paragraph 4, also requires entities to disclose significant commitments in the notes to their financial statements. GASB Statement 38, paragraph 10, requires disclosure of debt service requirements, which can be modified by interest rate swaps.

16. Technical Bulletins may also provide interim guidance applying existing Statements on problems currently under study. Insofar as the Board has adopted a project to study derivative reporting and measurement issues, this document provides guidance pending the results of that project.

Scope of This Technical Bulletin

17. The disclosures required by this document are limited to derivatives not reported at fair value on the statement of net assets. Many derivatives are already reported at fair value. For example, defined benefit pension plans report all investments, and consequently investment derivatives, at fair value. Embedded derivatives in an investment that GASB Statement 31 requires to be reported at fair value also are already reported on the statement of net assets. In those cases, the need for derivative disclosures is diminished. Statement 31 includes investment disclosure requirements for these investments, and as governments apply GASB Statement 40, interest rate risk and credit risk of those instruments will be disclosed.

18. This Technical Bulletin adopts the definition of derivatives established by the FASB in paragraphs 6 through 9 of Statement 133, as amended. Those paragraphs make reference to reporting requirements applicable to embedded derivatives in paragraph 12 of that Statement, as amended. Paragraph 12 indicates that there are contracts that do not meet the requirements of a derivative as defined earlier, but have terms that should be treated as embedded derivatives. Except as noted below, this Technical Bulletin is not intended to apply to embedded derivatives.

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[4]Governmental Accounting Standards Board, *Rules of Procedure* (Norwalk, CT: Governmental Accounting Standards Board, 2002), p. 21.

19. Derivative transactions may involve either cash receipts or cash payments at inception equal to the derivative's fair value; nevertheless, these derivatives would be included in the scope of this Technical Bulletin. Further, a prepaid interest rate swap—whether or not it is considered to be a derivative embedded in a host contract—is within the scope of this Technical Bulletin.

Other Literature

20. The requirements in this document are based on existing GASB disclosure requirements and on derivative requirements issued by the FASB.

21. The GASB staff has conducted research to provide assurance that financial statement users find this information useful. The staff believes that much of the TB 94-1 disclosure requirements are consistent with user needs; however, additional clarification was needed to provide comparable disclosures. In addition, a need for fair value information was identified. As the GASB continues to study derivative issues, information about the experience of preparers, auditors, and users working with this guidance will be useful to the GASB.

Existing Disclosure Requirements Not Addressed in This Technical Bulletin

22. Derivatives, like other financial transactions, are covered by existing authoritative accounting literature. This Technical Bulletin is not and cannot be a comprehensive compilation of all disclosure requirements. For example, the government's accounting policies that affect the manner of reporting derivative balances and cash flows on the financial statements are not discussed because they are a well-established requirement in the authoritative accounting literature. Likewise, violations of statute and legal risk (the risk that a derivative may be prohibited by law, regulation, or contract) are not addressed. As explained in the Basis for Conclusions of Statement 40—a Statement focused on risks of deposits and investments—the requirement to disclose significant legal violations and steps taken to address those violations are also well-established requirements in the authoritative accounting literature. Accordingly, neither Statement 40 nor this Technical Bulletin addresses legal risk or violations of legal requirements.

23. Consistent with NCGA Interpretation 6, paragraph 6, the topics contained in this Technical Bulletin are not intended to replace professional judgment in determining disclosure necessary for fair presentation in the circumstances.

Fair Value

24. Fair value information indicates the magnitude of a derivative's impact on a government's assets, liabilities, and cash flows. In staff's view, the dollar magnitude of a potential termination of a derivative is best communicated in terms of fair value. Statement 25 has required pension plans to report investments, including derivatives, at fair value since 1997. Applying a similar standard now, even though only disclosed in the notes, provides additional consistency of application between derivatives reported by pension plans and derivatives disclosed by all other governments. Other accounting literature also discusses estimating fair values when market quotations are not considered representative and a pricing service is used. For example, the AICPA Audit and Accounting Guide, *Audits of Investment Companies,* provides fair value guidance in paragraphs 2.34 through 2.38.

Credit Risk

25. GASB Statement 40 requires investment credit risk disclosures. The credit quality disclosures of this Technical Bulletin parallel the requirements of that Statement. The balance of the disclosures are based on the concentration of credit risk disclosures contained within FASB Statement 133, paragraph 531. The staff believes that potential credit losses should be based on a derivative's fair value and not some other measure. Because this Technical Bulletin is focused on derivatives not reported at fair value on the statement of net assets, staff believes that its credit risk disclosure requirements should not be limited to instances of *concentrations* of credit risk, as required by the FASB, but should be cast as credit risk disclosures.

Interest Rate Risk

26. Some derivatives cause the government to assume more interest rate risk. For example, a derivative's terms should be disclosed as interest rate risk when the government pays a variable rate and receives a fixed rate. Statement 40 also requires interest rate risk disclosures. Those requirements have not been incorporated into this Technical Bulletin because of the need to further study their effects in the derivatives environment. When fixed-rate bonds are associated with a receive-fixed, pay-variable interest rate swap, the combined instruments may behave as variable-rate debt. The interest rate disclosure requirement is also consistent with the variable-rate debt disclosure requirement in Statement 38. That is, the terms by which variable interest rates change are a required disclosure (Statement 38, paragraph 10b).

Termination Risk

27. A government may be exposed to termination risk either by the potential for payments if a termination occurs during adverse market conditions or by the potential for a synthetic instrument, such as a variable-rate debt obligation associated with a pay-fixed, receive-variable swap that creates a synthetic interest rate, to revert to its original form. Termination events are commonly established in derivative contract documents, and the probability that any of these events may occur is often considered remote. A requirement to disclose possible actions a government might take to address a swap termination is considered beyond the scope of a Technical Bulletin. Research indicates, however, that the dollar magnitude of a derivative's termination could be significant.

Effective Date

28. This Technical Bulletin is effective for periods ending after June 15, 2003. Staff acknowledges the short transition period, but believes that the effective date is justified (a) by the significance of the derivative disclosures, (b) because, except for fair value disclosures, the requirements of this Bulletin are a clarification of existing requirements, and (c) by research that indicates that derivatives dealers routinely estimate fair values.

Appendix 2

DEFINITION OF DERIVATIVE INSTRUMENTS

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* as Amended

29. The following excerpts are considered the most relevant portions of FASB Statement 133, as amended,[5] which address derivative definitions and scope exceptions. Other portions also may be relevant. Explanation of terms or elaboration on concepts found in the following portions may be found in the full text of the Statement, its appendixes, or implementation information. The following text is based on FASB Statement 149, Appendix B, "Amended Paragraphs of Statement 133 Marked to Show Changes Made by This Statement." Underlines and strikethroughs have been eliminated.

[5]To date, FASB Statement 133 has been amended by FASB Statements 138, 140, 141, and 149. Application of future amendments is required.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Derivative Instruments

6. A derivative instrument is a financial instrument or other contract with all three of the following characteristics:

a. It has (1) one or more **underlyings** and (2) one or more **notional amounts**[3] or payment provisions or both. Those terms determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required.[4]
b. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
c. Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

Notwithstanding the above characteristics, loan commitments that relate to the origination of mortgage loans that will be held for sale, as discussed in paragraph 21 of FASB Statement No. 65, *Accounting for Mortgage Banking Activities* (as amended), shall be accounted for as derivative instruments by the issuer of the loan commitment (that is, the potential lender). Paragraph 10(i) provides a scope exception for the accounting for loan commitments by issuers of certain commitments to originate loans and all holders of commitments to originate loans (that is, the potential borrowers).

7. *Underlying, notional amount, and payment provision*. An underlying is a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under a contract). An underlying may be a price or rate of an asset or liability but is not the asset or liability itself. A notional amount is a number of currency units, shares, bushels, pounds, or other units specified in the contract. The settlement of a derivative instrument with a notional amount is determined by interaction of that notional amount with the underlying. The interaction may be simple multiplication, or it may involve a formula with leverage factors or other constants. A payment provision specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner.

[3]Sometimes other names are used. For example, the notional amount is called a face amount in some contracts.

[4]The terms *underlying, notional amount, payments provision,* and *settlement* are intended to include the plural forms in the remainder of this Statement. Including both the singular and plural forms used in this paragraph is more accurate but much more awkward and impairs the readability.

8. *Initial net investment*. Many derivative instruments require no initial net investment. Some require an initial net investment as compensation for time value (for example, a premium on an option) or for terms that are more or less favorable than market conditions (for example, a premium on a forward purchase contract with a price less than the current forward price). Others require a mutual exchange of currencies or other assets at inception, in which case the net investment is the difference in the fair values of the assets exchanged. A derivative instrument does not require an initial net investment in the contract that is equal to the notional amount (or the notional amount plus a premium or minus a discount) or that is determined by applying the notional amount to the underlying. If the initial net investment in the contract (after adjustment for the time value of money) is less, by more than a nominal amount, than the initial net investment that would be commensurate with the amount that would be exchanged either to acquire the asset related to the underlying or to incur the obligation related to the underlying, the characteristic in paragraph 6(b) is met. The amount of that asset acquired or liability incurred should be comparable to the effective notional amount* of the contract.

9. *Net settlement*. A contract fits the description in paragraph 6(c) if its settlement provisions meet one of the following criteria:

a. Neither party is required to deliver an asset that is associated with the underlying and that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (or the notional amount plus a premium or minus a discount). For example, most interest rate swaps do not require that either party deliver interest-bearing assets with a principal amount equal to the notional amount of the contract.
b. One of the parties is required to deliver an asset of the type described in paragraph 9(a), but there is a market mechanism that facilitates net settlement, for example, an exchange that offers a ready opportunity to sell the contract or to enter into an offsetting contract.
c. One of the parties is required to deliver an asset of the type described in paragraph 9(a), but that asset is readily convertible to cash[5] or is itself a derivative instrument. An example of that type of contract is a forward contract that requires delivery of an exchange-traded equity security. Even though the number of shares to be delivered is

*The effective notional amount is the stated notional amount adjusted for any leverage factor.

[5]FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises,* states that assets that are readily convertible to cash "have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price" (paragraph 83(a)). For contracts that involve multiple deliveries of the asset, the phrase *in an active market that can rapidly absorb the quantity held by the entity* should be applied separately to the expected quantity in each delivery.

the same as the notional amount of the contract and the price of the shares is the underlying, an exchange-traded security is readily convertible to cash. Another example is a swaption—an option to require delivery of a swap contract, which is a derivative.

Derivative instruments embedded in other contracts are addressed in paragraphs 12–16.

10. Notwithstanding the conditions in paragraphs 6–9, the following contracts are not subject to the requirements of this Statement:

a. *"Regular-way" security trades.* Regular-way security trades are contracts that provide for delivery of a security within the time generally established by regulations or conventions in the marketplace or exchange in which the transaction is being executed. However, a contract for an existing security does not qualify for the regular-way security trades exception if it requires or permits net settlement (as discussed in paragraphs 9(a) and 57(c)(1)) or if a market mechanism to facilitate net settlement of that contract (as discussed in paragraphs 9(b) and 57(c)(2)) exists, except as provided in the following sentence. If an entity is required to account for a contract to purchase or sell an existing security on a trade-date basis, rather than a settlement-date basis, and thus recognizes the acquisition (or disposition) of the security at the inception of the contract, then the entity shall apply the regular-way security trades exception to that contract. A contract for the purchase or sale of *when-issued* securities or other securities that do not yet exist is addressed in paragraph 59(a).
b. *Normal purchases and normal sales*. Normal purchases and normal sales are contracts that provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. The following guidance should be considered in determining whether a specific type of contract qualifies for the normal purchases and normal sales exception:
   (1) *Forward contracts (non-option-based contracts).* Forward contracts are eligible to qualify for the normal purchases and normal sales exception. However, forward contracts that contain net settlement provisions as described in either paragraph 9(a) or paragraph 9(b) are not eligible for the normal purchases and normal sales exception unless it is probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery.* Net settlement (as described in paragraphs 9(a) and 9(b)) of contracts in a group of contracts similarly designated as normal purchases and normal sales would call into question the classification of all such contracts as normal purchases or normal sales. Contracts that require cash settlements of gains or losses

*Contracts that are subject to unplanned netting (referred to as a "book out" in the electricity utility industry) do not qualify for this exception except as specified in paragraph 58(b).

or are otherwise settled net on a periodic basis, including individual contracts that are part of a series of sequential contracts intended to accomplish ultimate acquisition or sale of a commodity, do not qualify for this exception.

(2) *Freestanding option contracts*. Option contracts that would require delivery of the related asset at an established price under the contract only if exercised are not eligible to qualify for the normal purchases and normal sales exception, except as indicated in paragraph 10(b)(4) below.

(3) *Forward contracts that contain optionality features.* Forward contracts that contain optionality features that do not modify the quantity of the asset to be delivered under the contract are eligible to qualify for the normal purchases and normal sales exception. Except for power purchase or sales agreements addressed in paragraph 10(b)(4), if an option component permits modification of the quantity of the assets to be delivered, the contract is not eligible for the normal purchases and normal sales exception, unless the option component permits the holder only to purchase or sell additional quantities at the market price at the date of delivery. In order for forward contracts that contain optionality features to qualify for the normal purchases and normal sales exception, the criteria discussed in paragraph 10(b)(1) must be met.

(4) *Power purchase or sales agreements.* Notwithstanding the criteria in paragraphs 10(b)(1) and 10(b)(3), a power purchase or sales agreement (whether a forward contract, option contract, or a combination of both) that is a **capacity contract** also qualifies for the normal purchases and normal sales exception if it meets the criteria in paragraph 58(b).

However, contracts that have a price based on an underlying that is not clearly and closely related to the asset being sold or purchased (such as a price in a contract for the sale of a grain commodity based in part on changes in the S&P index) or that are denominated in a foreign currency that meets none of the criteria in paragraphs 15(a)–15(d) shall not be considered normal purchases and normal sales. For contracts that qualify for the normal purchases and normal sales exception, the entity shall document the designation of the contract as a normal purchase or normal sale. For contracts that qualify for the normal purchases and normal sales exception under paragraphs 10(b)(1) and 10(b)(3), the entity shall document the basis for concluding that it is probable that the contract will not settle net and will result in physical delivery. For contracts that qualify for the normal purchases and normal sales exception under paragraph 10(b)(4), the entity shall document the basis for concluding that the agreement meets the criteria in paragraph 58(b). The documentation requirements can be applied either to groups of similarly designated contracts or to each individual contract. Failure to comply with the documentation requirements precludes application of the normal purchases and normal sales exception to contracts that would otherwise qualify for that exception.

c. *Certain insurance contracts.* Generally, contracts of the type that are within the scope of FASB Statements No. 60, *Accounting and Reporting by Insurance Enterprises,* No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments,* and No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* are not subject to the requirements of this Statement whether or not they are written by insurance enterprises. That is, a contract is not subject to the requirements of this Statement if it entitles the holder to be compensated only if, as a result of an identifiable insurable event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk. The following types of contracts written by insurance enterprises or held by the insureds are not subject to the requirements of this Statement for the reasons given:
   (1) *Traditional life insurance contracts.* The payment of death benefits is the result of an identifiable insurable event (death of the insured) instead of changes in a variable.
   (2) *Traditional property and casualty contracts.* The payment of benefits is the result of an identifiable insurable event (for example, theft or fire) instead of changes in a variable.

   However, insurance enterprises enter into other types of contracts that may be subject to the provisions of this Statement. In addition, some contracts with insurance or other enterprises combine derivative instruments, as defined in this Statement, with other insurance products or nonderivative contracts, for example, indexed annuity contracts, variable life insurance contracts, and property and casualty contracts that combine traditional coverages with foreign currency options. Contracts that consist of both derivative portions and nonderivative portions are addressed in paragraph 12.

d. *Financial guarantee contracts.* Financial guarantee contracts are not subject to this Statement only if:
   (1) They provide for payments to be made solely to reimburse the guaranteed party for failure of the debtor to satisfy its required payment obligations under a nonderivative contract, either at pre-specified payment dates or accelerated payment dates as a result of the occurrence of an event of default (as defined in the financial obligation covered by the guarantee contract) or notice of acceleration being made to the debtor by the creditor.
   (2) Payment under the financial guarantee contract is made only if the debtor's obligation to make payments as a result of conditions as described in (1) above is past due.
   (3) The guaranteed party is, as a precondition in the contract (or in the back-to-back arrangement, if applicable) for receiving payment of any claim under the guarantee, exposed to the risk of nonpayment both at inception of the financial guarantee contract and throughout its term either through direct legal ownership of the guaranteed obligation or through a back-to-back arrangement with another party that is

required by the back-to-back arrangement to maintain direct ownership of the guaranteed obligation.

In contrast, financial guarantee contracts are subject to this Statement if they do not meet all of the above three criteria, for example, if they provide for payments to be made in response to changes in another underlying such as a decrease in a specified debtor's creditworthiness.

e. *Certain contracts that are not traded on an exchange.* Contracts that are not exchange-traded are not subject to the requirements of this Statement if the underlying on which the settlement is based is one of the following:
   (1) A climatic or geological variable or other physical variable
   (2) The price or value of (a) a nonfinancial asset of one of the parties to the contract provided that the asset is not readily convertible to cash or (b) a nonfinancial liability of one of the parties to the contract provided that the liability does not require delivery of an asset that is readily convertible to cash
   (3) Specified volumes of sales or service revenues of one of the parties to the contract.

   If a contract has more than one underlying and some, but not all, of them qualify for one of the exceptions in paragraphs 10(e)(1), 10(e)(2), and 10(e)(3), the application of this Statement to that contract depends on its predominant characteristics. That is, the contract is subject to the requirements of this Statement if all of its underlyings, considered in combination, behave in a manner that is highly correlated with the behavior of any of the component variables that do not qualify for an exception.

f. *Derivatives that serve as impediments to sales accounting.* A derivative instrument (whether freestanding or embedded in another contract) whose existence serves as an impediment to recognizing a related contract as a sale by one party or a purchase by the counterparty is not subject to this Statement. For example, the existence of a guarantee of the residual value of a leased asset by the lessor may be an impediment to treating a contract as a sales-type lease, in which case the contract would be treated by the lessor as an operating lease. Another example is the existence of a call option enabling a transferor to repurchase transferred assets that is an impediment to sales accounting under FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

g. *Investments in life insurance.* A policyholder's investment in a life insurance contract that is accounted for under FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance,* is not subject to this Statement. The exception in this subparagraph affects only the accounting by the policyholder; it does not affect the accounting by the issuer of the life insurance contract.

h. *Certain investment contracts.* A contract that is accounted for under either paragraph 4 of FASB Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts,* or paragraph 12 of FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans,* as amended by Statement 110, is not subject to this Statement. Similarly, a contract that is accounted for under either paragraph 4 or paragraph 5 of AICPA Statement of Position 94-4, *Reporting of Investment Contracts*

Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans, is not subject to this Statement. Those exceptions apply only to the party that accounts for the contract under Statement 35, Statement 110, or SOP 94-4.

i. *Loan commitments.* The holder of any commitment to originate a loan (that is, the potential borrower) is not subject to the requirements of this Statement. Issuers of commitments to originate mortgage loans that will be held for investment purposes, as discussed in paragraphs 21 and 25 of Statement 65, are not subject to this Statement. In addition, issuers of loan commitments to originate other types of loans (that is, other than mortgage loans) are not subject to the requirements of this Statement.

Paragraphs 57 and 59 of FASB Statement 133, as amended, also provide guidance on the definition of derivatives.

Appendix 3

NONAUTHORITATIVE ILLUSTRATIONS OF DISCLOSURES

30. The discussions and accompanying excerpts of disclosures in this appendix are designed to illustrate the general requirements discussed in the response to Question 2. Each illustration is based on particular circumstances; it generally would be inappropriate to use the wording verbatim for actual situations. The facts assumed in these examples are illustrative only and are not intended to modify or limit the provisions of this Technical Bulletin or to indicate endorsement of the policies or practices shown. Application of the provisions of this Technical Bulletin may require disclosures and formats other than those illustrated here.

> Other disclosure requirements, not covered in this Technical Bulletin, also apply. For example, a summary of significant accounting policies, significant violations of legal or contractual provisions, and a government's steps taken to address such violations are required disclosures discussed in other authoritative accounting literature. NCGA Interpretation 6 and GASB Statement 38 describe many of those disclosure requirements.

CONTENTS

Illustration 1

Pay-Fixed, Receive-Variable Interest Rate Swap

Assumptions

Objective of the interest rate swap. As a means to lower its borrowing costs, when compared against fixed-rate bonds at the time of issuance in July 2001, an authority entered into an interest rate swap in connection with its $100 million 2001 Series A variable-rate revenue bonds. The intention of the swap was to effectively change the authority's variable interest rate on the bonds to a synthetic fixed rate of 3.0 percent.

Terms. Under the swap, the authority pays the counterparty a fixed payment of 3.0 percent and receives a variable payment computed as 65 percent of the London Interbank Offered Rate (LIBOR). The swap has a notional amount of $100 million and the associated variable-rate bond has a $100 million principal amount. The swap was entered into at the same time the bonds were issued (July 2001). Starting in fiscal year 2009, the notional value of the swap and the principal amount of the associated debt decline by $20 million per year until the debt is completely retired. The bonds' variable-rate coupons are based on The Bond Market Association Municipal Swap Index™ (BMA). The bonds and the related swap agreement mature on June 30, 2013. As of June 30, 2003, rates were as follows:

	Terms	Rates
Interest rate swap:		
Fixed payment to counterparty	Fixed	3.0%
Variable payment from counterparty	65% of LIBOR	(1.6%)
Net interest rate swap payments		1.4%
Variable-rate bond coupon payments	BMA	1.5%
Synthetic interest rate on bonds		2.9%

Fair value. As of June 30, 2003, the swap had a negative fair value of $5,210,000. The negative fair value of the swap may be countered by reductions in total interest payments required under the variable-rate bond, creating lower synthetic rates. Because the coupons on the government's variable-rate bonds adjust to changing interest rates, the bonds do not have a corresponding fair value increase. The fair value was developed by a pricing service using the zero-coupon method. This method calculates the future net settlement payments required by the swap, assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement of the swap.

Credit risk. As of June 30, 2003, the authority was not exposed to credit risk because the swap had a negative fair value. However, should interest rates change and the fair value of the swap becomes positive, the authority would be exposed to credit risk in the amount of the derivative's fair value. The swap counterparty was rated AA by Fitch Ratings and Standard & Poor's and Aa by Moody's Investors Service as of June 30, 2003. To mitigate the potential for credit risk, if the counterparty's credit quality falls below AA/Aa, the fair value of the swap will be fully collateralized by the counterparty with U.S. government securities. Collateral would be posted with a third-party custodian.

Basis risk. As noted above, the swap exposes the authority to basis risk should the relationship between LIBOR and BMA converge, changing the synthetic rate on the bonds. If a change occurs that results in the rates' moving to convergence, the expected cost savings may not be realized.

Termination risk. The derivative contract uses the International Swap Dealers Association Master Agreement, which includes standard termination events, such as failure to pay and bankruptcy. The Schedule to the Master Agreement includes an "additional termination event." That is, the swap may be terminated by the authority if the counterparty's credit quality rating falls below "A–" as issued by Fitch Ratings or Standard & Poor's or "A3" as issued by Moody's Investors Service. The authority or the counterparty may terminate the swap if the other party fails to perform under the terms of the contract. If the swap is terminated, the variable-rate bond would no longer carry a synthetic interest rate. Also, if at the time of termination the swap has a negative fair value, the authority would be liable to the counterparty for a payment equal to the swap's fair value.

Swap payments and associated debt. As of June 30, 2003, debt service requirements of the variable-rate debt and net swap payments, *assuming current interest rates remain the same,* for their term were as follows. As rates vary, variable-rate bond interest payments and net swap payments will vary.

Fiscal Year Ending June 30	Variable-Rate Bonds		Interest Rate Swaps, Net	Total
	Principal	Interest		
2004	$ —	$ 1,500,000	$ 1,400,000*	$ 2,900,000
2005	—	1,500,000	1,400,000	2,900,000
2006	—	1,500,000	1,400,000	2,900,000
2007	—	1,500,000	1,400,000	2,900,000
2008	—	1,500,000	1,400,000	2,900,000
2009	20,000,000	1,500,000	1,400,000	22,900,000
2010	20,000,000	1,200,000	1,120,000	22,320,000
2011	20,000,000	900,000	840,000	21,740,000
2012	20,000,000	600,000	560,000	21,160,000
2013	20,000,000	300,000	280,000	20,580,000
Total	$100,000,000	$12,000,000	$11,200,000	$123,200,000

*Computed: (3.0% – 1.6%) × $100,000,000.

Disclosures

Interest rate swap

Objective of the interest rate swap. As a means to lower its borrowing costs, when compared against fixed-rate bonds at the time of issuance in July 2001, the authority entered into an interest rate swap in connection with its $100 million 2001 Series A variable-rate revenue bonds. The intention of the swap was to effectively change the authority's variable interest rate on the bonds to a synthetic fixed rate of 3.0 percent.

Terms. The bonds and the related swap agreement mature on June 30, 2013, and the swap's notional amount of $100 million matches the $100 million variable-rate bonds. The swap was entered at the same time the bonds were issued (July 2001). Starting in fiscal year 2009, the notional value of the swap and the principal amount of the associated debt decline. Under the swap, the authority pays the counterparty a fixed payment of 3.0 percent and receives a variable payment computed as 65 percent of the London Interbank Offered Rate (LIBOR). Conversely, the bond's variable-rate coupons are based on The Bond Market Association Municipal Swap Index™ (BMA).

Fair value. Because interest rates have declined since execution of the swap, the swap had a negative fair value of $5,210,000 as of June 30, 2003. The swap's negative fair value may be countered by a reduction in total interest payments required under the variable-rate bonds, creating a lower synthetic interest rate. Because the coupons on the government's variable-rate bonds adjust to changing interest rates, the bonds do not have a corresponding fair value increase. The fair value was estimated using the zero-coupon method. This method calculates the future net settlement payments required by the swap, assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement on the swap.

Credit risk. As of June 30, 2003, the authority was not exposed to credit risk because the swap had a negative fair value. However, should interest rates change and the fair value of the swap becomes positive, the authority would be exposed to credit risk in the amount of the derivative's fair value. The swap counterparty was rated AA by Fitch Ratings and Standard & Poor's and Aa by Moody's Investors Service as of June 30, 2003. To mitigate the potential for credit risk, if the counterparty's credit quality falls below AA/Aa, the fair value of the swap will be fully collateralized by the counterparty with U.S. government securities. Collateral would be posted with a third-party custodian.

Basis risk. The swap exposes the government to basis risk should the relationship between LIBOR and BMA converge, changing the synthetic rate on the bonds. The effect of this difference in basis is indicated by the difference between the intended synthetic rate (3.0 percent) and the synthetic rate as of June 30, 2003 (2.9 percent). If a change occurs that results in the rates' moving to convergence, the expected cost savings may not be realized. As of June 30, 2003, the BMA rate was 1.5 percent, whereas 65 percent of LIBOR was 1.6 percent.

Termination risk. The authority or the counterparty may terminate the swap if the other party fails to perform under the terms of the contract. The swap may be terminated by the authority if the counterparty's credit quality rating falls below "A–" as issued by Fitch Ratings or Standard & Poor's or "A3" as issued by Moody's Investors Service. If the swap is terminated, the variable-rate bond would no longer carry a synthetic interest rate. Also, if at the time of termination the swap has a negative fair value, the authority would be liable to the counterparty for a payment equal to the swap's fair value.

The following disclosure should be included in the authority's long-term debt disclosure. It should be appropriately captioned and cross-referenced to the derivative note.

Swap payments and associated debt. Using rates as of June 30, 2003, debt service requirements of the variable-rate debt and net swap payments, *assuming current interest rates remain the same* for their term, were as follows. As rates vary, variable-rate bond interest payments and net swap payments will vary.

Fiscal Year Ending June 30	Variable-Rate Bonds		Interest Rate Swaps, Net	Total
	Principal	Interest		
2004	$ —	$ 1,500,000	$ 1,400,000	$ 2,900,000
2005	—	1,500,000	1,400,000	2,900,000
2006	—	1,500,000	1,400,000	2,900,000
2007	—	1,500,000	1,400,000	2,900,000
2008	—	1,500,000	1,400,000	2,900,000
2009–2013	100,000,000	4,500,000	4,200,000	108,700,000
Total	$100,000,000	$12,000,000	$11,200,000	$123,200,000

Illustration 2

Multiple Pay-Fixed, Receive-Variable Interest Rate Swaps

Assumptions

Objective of the swaps. In order to protect against the potential of rising interest rates, a housing finance authority entered into twelve separate pay-fixed, receive-variable interest rate swaps at a cost anticipated to be less than what the authority would have paid to issue fixed-rate debt.

Terms, fair values, and credit risk. The terms, fair values, and credit ratings of the outstanding swaps as of June 30, 2003, were as follows. The notional amounts of the swaps match the principal amounts of the associated debt. Except as discussed under rollover risk, the authority's swap agreements contain scheduled reductions to outstanding notional amounts that are expected to approximately follow scheduled or anticipated reductions in the associated "bonds payable" category.

Associated Bond Issue	Notional Amounts	Effective Date	Fixed Rate Paid	Variable Rate Received	Fair Values	Swap Termination Date	Counterparty Credit Rating
HMRB*1999A	$ 60,450,000	08/27/99	5.540%	BMA†	$ (5,240,325)	June 2014	AA/Aa
HMRB 2000A	32,250,500	06/08/00	4.650%	BMA	(3,647,458)	June 2015	AA/Aa
HMRB 2000B	5,000,000	06/08/00	5.250%	65% of LIBOR‡	(856,234)	June 2015	AA/Aaa
HMRB 2000B2	12,550,000	09/28/00	5.150%	65% of LIBOR	(1,243,384)	June 2012	AA/Aa2
HMRB 2001A	54,234,000	02/14/01	3.750%	BMA	(458,244)	June 2017	AA/Aa
HMRB 2001C	13,470,000	02/14/01	3.645%	65% of LIBOR	(234,541)	June 2012	AA/Aa
HMRB 2002A	25,000,000	09/28/02	3.254%	BMA	(149,957)	June 2007	AA/Aa
MHRB§2000A	36,785,000	12/16/00	4.144%	BMA	(1,135,869)	June 2015	AAA/Aaa
MHRB 2001B	12,948,000	05/31/01	3.987%	65% of LIBOR	(459,834)	June 2020‖	AA/Aa1
MHRB 2001B2	23,234,480	07/31/01	4.230%	65% of LIBOR	(549,038)	June 2011	AAA/Aaa
MHRB 2002A	12,934,380	02/17/02	3.863%	BMA	(65,985)	June 2012	AA/Aa2
MHRB 2003A	34,560,000	04/15/03	3.145%	BMA	(46,234)	June 2013	AAA/Aaa
Total	$323,416,360				$(14,087,103)		

*Home mortgage revenue bonds.

†The Bond Market Association Municipal Swap Index™.

‡London Interbank Offered Rate.

§Multifamily housing finance bonds.

‖The counterparty has the option to terminate the swap each June 30, commencing June 30, 2016.

Fair value. Because interest rates have declined, all swaps had a negative fair value as of June 30, 2003. The negative fair values may be countered by reductions in total interest payments required under the variable-rate bonds, creating lower synthetic interest rates. Because the coupons on the government's variable-rate bonds adjust to changing interest rates, the bonds do not have corresponding fair value increases. The fair values were estimated using the zero-coupon method. This method calculates the future net settlement payments required by the swap, assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement on the swaps.

Credit risk. As of June 30, 2003, the authority was not exposed to credit risk because the swaps had negative fair values. However, should interest rates change and the fair values of the swaps become positive, the authority would be exposed to credit risk in the amount of the derivatives' fair value.

The swap agreements contain varying collateral agreements with the counterparties. The swaps require full collateralization of the fair value of the swap should the counterparty's credit rating fall below AA as issued by Fitch Ratings and Standard & Poor's or Aa as issued by Moody's Investors Service. Collateral on all swaps is to be in the form of U.S. government securities held by a third-party custodian.

The authority also enters into master netting agreements when the authority has entered into more than one derivative transaction with one counterparty. Under the terms of these agreements, should one party become insolvent or otherwise default on its obligations, close-out netting provisions permit the nondefaulting party to accelerate and terminate all outstanding transactions and net the transactions' fair values so that a single sum will be owed by, or owed to, the nondefaulting party.

Although the authority executes swap transactions with various counterparties, four swaps, approximating 53 percent of the notional amount of swaps outstanding, are held with one counterparty. That counterparty is rated AA/Aa. Of the remaining swaps, the authority holds three agreements with another counterparty, rated AAA/Aaa, approximating 29 percent of the outstanding notional value. All other swaps are held with separate counterparties. Those counterparties are rated AA/Aa or better.

Basis risk. The authority is exposed to basis risk on the swaps when the variable payment received is based on an index other than BMA. Should the relationship between LIBOR and BMA move to convergence, the expected cost savings may

not be realized. The statutory authority of the housing finance authority requires that the authority issue variable-rate debt with coupon payments equivalent to BMA. As of June 30, 2003, the BMA rate was 1.5 percent, whereas 65 percent of LIBOR was 1.6 percent.

Termination risk. The authority or the counterparty may terminate any of the swaps if the other party fails to perform under the terms of the contract. In addition, the authority is exposed to termination risk on the swap related to the multifamily housing revenue bonds (MHRB) 2001B. The associated swap provides the counterparty with the option to terminate the swap agreement each June 30, commencing June 30, 2016. If any of the swaps is terminated, the associated variable-rate bonds would no longer carry synthetic interest rates. Also, if at the time of termination the swap has a negative fair value, the authority would be liable to the counterparty for a payment equal to the swap's fair value.

Rollover risk. The authority is exposed to rollover risk on swaps that mature or may be terminated prior to the maturity of the associated debt. When these swaps terminate, or in the case of the termination option, if the counterparty exercises its option, the authority will not realize the synthetic rate offered by the swaps on the underlying debt issues. The following swaps expose the authority to rollover risk:

Associated Debt Issuance	Debt Maturity Date	Swap Termination Date
HMRB 2000B2	June 2020	June 2012
HMRB 2001A	June 2031	June 2017
HMRB 2001C	June 2016	June 2012
MHRB 2001B	June 2020	June 2020*

*The swap may be terminated each June 30, beginning June 30, 2016.

Swap payments and associated debt. As of June 30, 2003, debt service requirements of the authority's outstanding variable-rate debt and net swap payments, *assuming current interest rates remain the same,* for their term are as follows:

Fiscal Year Ending June 30	Variable-Rate Bonds		Interest Rate Swaps, Net	Total
	Principal	Interest		
2004	$ —	$ 4,918,448	$ 8,787,205	$ 13,705,653
2005	—	4,918,448	8,787,205	13,705,653
2006	—	4,918,448	8,787,205	13,705,653
2007	25,000,000	4,543,448	8,348,705	37,892,153
2008	—	4,543,448	8,348,705	12,892,153
2009–2013	70,728,860	20,695,554	37,288,559	128,712,973
2014–2018	147,955,500	7,653,963	7,377,125	162,986,588
2019–2023	25,498,000	4,475,518	309,069	30,282,587
2024–2028	—	4,067,550	—	4,067,550
2029–2031	54,234,000	1,627,020	—	55,861,020
Total	$323,416,360	$62,361,845	$88,033,778	$473,811,983

As rates vary, variable-rate bond interest payments and net swap payments will vary.

Disclosure

Objective of the swaps. In order to protect against the potential of rising interest rates, the authority entered twelve separate pay-fixed, receive-variable interest rate swaps at a cost less than what the authority would have paid to issue fixed-rate debt.

Terms, fair values, and credit risk. The terms, including the fair values and credit ratings of the outstanding swaps as of June 30, 2003, are as follows. The notional amounts of the swaps match the principal amounts of the associated debt. Except as discussed under rollover risk, the authority's swap agreements contain scheduled reductions to outstanding notional amounts that are expected to approximately follow scheduled or anticipated reductions in the associated "bonds payable" category.

Associated Bond Issue	Notional Amounts	Effective Date	Fixed Rate Paid	Variable Rate Received	Fair Values	Swap Termination Date	Counterparty Credit Rating
HMRB*1999A	$ 60,450,000	08/27/99	5.540%	BMA†	$ (5,240,325)	June 2014	AA/Aa
HMRB 2000A	32,250,500	06/08/00	4.650%	BMA	(3,647,458)	June 2015	AA/Aa
HMRB 2000B	5,000,000	06/08/00	5.250%	65% of LIBOR‡	(856,234)	June 2015	AA/Aaa
HMRB 2000B2	12,550,000	09/28/00	5.150%	65% of LIBOR	(1,243,384)	June 2012	AA/Aa2
HMRB 2001A	54,234,000	02/14/01	3.750%	BMA	(458,244)	June 2017	AA/Aa
HMRB 2001C	13,470,000	02/14/01	3.645%	65% of LIBOR	(234,541)	June 2012	AA/Aa
HMRB 2002A	25,000,000	09/28/02	3.254%	BMA	(149,957)	June 2007	AA/Aa
MHRB§2000A	36,785,000	12/16/00	4.144%	BMA	(1,135,869)	June 2015	AAA/Aaa
MHRB 2001B	12,948,000	05/31/01	3.987%	65% of LIBOR	(459,834)	June 2020‖	AA/Aa1
MHRB 2001B2	23,234,480	07/31/01	4.230%	65% of LIBOR	(549,038)	June 2011	AAA/Aaa
MHRB 2002A	12,934,380	02/17/02	3.863%	BMA	(65,985)	June 2012	AA/Aa2
MHRB 2003A	34,560,000	04/15/03	3.145%	BMA	(46,234)	June 2013	AAA/Aaa
	$323,416,360				$(14,087,103)		

*Home mortgage revenue bonds.

†The Bond Market Association Municipal Swap Index™.

‡London Interbank Offered Rate.

§Multifamily housing revenue bonds.

‖The counterparty has the option to terminate the swap each June 30, commencing June 30, 2016.

Fair value. Because interest rates have declined, all swaps had a negative fair value as of June 30, 2003. The negative fair values may be countered by reductions in total interest payments required under the variable-rate bonds, creating lower synthetic interest rates. Because the coupons on the government's variable-rate bonds adjust to changing interest rates, the bonds do not have corresponding fair value increases. The fair values were estimated using the zero-coupon method. This method calculates the future net settlement payments required by the swap, assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement on the swaps.

As of June 30, 2003, the authority was not exposed to credit risk on any of its outstanding swaps because the swaps had negative fair values. However, should interest rates change and the fair values of the swaps become positive, the authority would be exposed to credit risk in the amount of the derivatives' fair value.

The swap agreements contain varying collateral agreements with the counterparties. The swaps require full collateralization of the fair value of the swap should the counterparty's credit rating fall below AA as issued by Fitch Ratings and Standard & Poor's or Aa as issued by Moody's Investors Service. Collateral on all swaps is to be in the form of U.S. government securities held by a third-party custodian.

The authority also enters into master netting agreements when the authority has entered into more than one derivative transaction with one counterparty. Under the terms of these agreements, should one party become insolvent or otherwise default on its obligations, close-out netting provisions permit the nondefaulting party to accelerate and terminate all outstanding transactions and net the transactions' fair values so that a single sum will be owed by, or owed to, the nondefaulting party.

Although the authority executes swap transactions with various counterparties, four swaps, approximating 53 percent of the notional amount of swaps outstanding, are held with one counterparty. That counterparty is rated AA/Aa. Of the remaining swaps, the authority holds three agreements with another counterparty, rated AAA/Aaa, approximating 29 percent of the outstanding notional value. All other swaps are held with separate counterparties. Those counterparties are rated AA/Aa or better.

Basis risk. The authority's variable-rate bond coupon payments are equivalent to the BMA rate. For those swaps for which the authority receives a variable-rate payment other than BMA, the authority is exposed to basis risk should the relationship

between LIBOR and BMA converge. If a change occurs that results in the rates' moving to convergence, the expected cost savings may not be realized. As of June 30, 2003, the BMA rate was 1.5 percent, whereas 65 percent of LIBOR was 1.6 percent.

Termination risk. The authority or the counterparty may terminate any of the swaps if the other party fails to perform under the terms of the contract. In addition, the authority is exposed to termination risk on the swap related to the multifamily housing revenue bonds (MHRB) 2001B. The associated swap provides the counterparty with the option to terminate the swap agreement each June 30, commencing June 30, 2016. If any of the swaps is terminated, the associated variable-rate bonds would no longer carry synthetic interest rates. Also, if at the time of termination the swap has a negative fair value, the authority would be liable to the counterparty for a payment equal to the swap's fair value.

Rollover risk. The authority is exposed to rollover risk on swaps that mature or may be terminated prior to the maturity of the associated debt. When these swaps terminate, or in the case of the termination option, if the counterparty exercises its option, the authority will not realize the synthetic rate offered by the swaps on the underlying debt issues. The following debt is exposed to rollover risk:

Associated Debt Issuance	Debt Maturity Date	Swap Termination Date
HMRB 2000B2	June 2020	June 2012
HMRB 2001A	June 2031	June 2017
HMRB 2001C	June 2016	June 2012
MHRB 2001B	June 2020	June 30, 2020*

*The swap may be terminated each June 30, beginning June 30, 2016.

The following disclosure should be included in the authority's long-term debt disclosure. It should be appropriately captioned and cross-referenced to the derivative note.

Swap payments and associated debt. Using rates as of June 30, 2003, debt service requirements of the authority's outstanding variable-rate debt and net swap payments are as follows. As rates vary, variable-rate bond interest payments and net swap payments will vary.

Fiscal Year Ending June 30	Variable-Rate Bonds		Interest Rate Swaps, Net	Total
	Principal	Interest		
2004	$ —	$ 4,918,448	$ 8,787,205	$ 13,705,653
2005	—	4,918,448	8,787,205	13,705,653
2006	—	4,918,448	8,787,205	13,705,653
2007	25,000,000	4,543,448	8,348,705	37,892,153
2008	—	4,543,448	8,348,705	12,892,153
2009–2013	70,728,860	20,695,554	37,288,559	128,712,973
2014–2018	147,955,500	7,653,963	7,377,125	162,986,588
2019–2023	25,498,000	4,475,518	309,069	30,282,587
2024–2028	—	4,067,550	—	4,067,550
2029–2031	54,234,000	1,627,020	—	55,861,020
Total	$323,416,360	$62,361,845	$88,033,778	$473,811,983

Illustration 3

Pay-Variable, Receive-Fixed Interest Rate Swap

This illustration indicates that the authority is assuming greater interest rate risk. The use of this type of derivative in other contexts may be intended to lower interest rate risk.

Assumptions

Objective of the interest rate swap. An authority's asset/liability strategy is to have a mixture of fixed- and variable-rate debt to take advantage of market fluctuations. Because the authority anticipated that interest rates might decline, it decided to synthetically create variable-rate debt by entering into a derivative.

Terms. In January 2001, the authority entered into a pay-variable, receive-fixed interest rate swap for the remaining term of its $300 million 1994, 4 percent revenue bonds. The notional value of the swap is $300 million. Under the terms of the swap, entered into in 2001 and scheduled to end in 2013, the authority pays a variable rate equivalent to The Bond Market Association Municipal Swap Index™ (BMA), which was 1.5 percent at June 30, 2003, and receives fixed-rate payments at 3.2 percent. The variable rate on the swap has an interest rate cap of 15 percent. Starting in fiscal year 2009, the notional value of the swap and the principal amount of the associated debt decline by $60 million per year until the debt is retired. As of June 30, 2003, the swap created a synthetic variable-rate bond as follows:

	Terms	Rates
Interest rate swap:		
Variable payment to counterparty	BMA	1.5%
Fixed payment from counterparty	Fixed	(3.2%)
Net interest rate swap payments		(1.7%)
Fixed-rate bond coupon payments	Fixed	4.0%
Synthetic variable interest rate on bonds		2.3%

Fair value. As of June 30, 2003, the swap had a positive fair value of $9,550,000. The fair value of the swap was calculated using the par-value method: the fixed rate on the swap was compared with the current fixed rates that could be achieved in the marketplace should the swap be unwound. The fixed-rate component was valued by discounting the fixed-rate cash flows using the current yield to maturity of a comparable bond. The variable-rate component was assumed to be at par value because the interest rate resets to the market rate at every reset date. The fair value was then calculated by subtracting the established market value of the fixed component from the established market value of the variable component (the par value of the bond).

Credit risk. The swap's fair value represented the authority's credit exposure to the counterparty as of June 30, 2003. Should the counterparty to this transaction fail to perform according to the terms of the swap contract, the authority faced

a maximum possible loss equivalent to the swap's $9,550,000 fair value. As of June 30, 2003, the swap counterparty was rated Aa by Moody's Investors Service and AA by Standard & Poor's and Fitch Ratings. To mitigate credit risk, if the counterparty's credit quality falls below Aa/AA, the fair value of the swap will be fully collateralized by the counterparty with U.S. government securities. Collateral would be posted with a third-party custodian.

Interest rate risk. The swap increases the authority's exposure to interest rate risk. As BMA increases, the city's net payment on the swap increases.

Termination risk. The authority or the counterparty may terminate the swap if the other party fails to perform under the terms of the contract. In addition, the counterparty may terminate the agreement each May 1 and November 1, commencing on May 1, 2011. If at the time of termination the swap has a negative fair value, the authority would be liable to the counterparty for that payment.

Swap payments and associated debt. Using interest rates as of June 30, 2003, principal and interest requirements of the debt and net swap payments for the term of the swap and the debt are as follows. As rates vary, net swap payments will vary.

Fiscal Year Ending June 30	Fixed-Rate Bonds		Interest Rate Swaps, Net	Total
	Principal	Interest		
2004	$ —	$12,000,000	$ (5,100,000)*	$ 6,900,000
2005	—	12,000,000	(5,100,000)	6,900,000
2006	—	12,000,000	(5,100,000)	6,900,000
2007	—	12,000,000	(5,100,000)	6,900,000
2008	—	12,000,000	(5,100,000)	6,900,000
2009	60,000,000	12,000,000	(5,100,000)	66,900,000
2010	60,000,000	9,600,000	(4,080,000)	65,520,000
2011	60,000,000	7,200,000	(3,060,000)	64,140,000
2012	60,000,000	4,800,000	(2,040,000)	62,760,000
2013	60,000,000	2,400,000	(1,020,000)	61,380,000
Total	$300,000,000	$96,000,000	$(40,800,000)	$355,200,000

*Computed: (1.5% – 3.2%) × $300,000,000.

Disclosures

Interest rate swap

Objective of the interest rate swap. The authority's asset/liability strategy is to have a mixture of fixed- and variable-rate debt to take advantage of market fluctuations. Because the authority anticipates that interest rates might decline, it decides to synthetically create variable-rate debt by entering into a derivative.

Terms. In January 2001, the authority entered into a pay-variable, receive-fixed interest rate swap for the remaining term of its $300 million 1994, 4 percent revenue bonds. The notional value of the swap is $300 million. Under the terms of the swap, entered into in 2001 and scheduled to end in 2013, the authority pays a rate equivalent to The Bond Market Association Municipal Swap Index™ (BMA), which was 1.5 percent at June 30, 2003, and receives fixed-rate payments at 3.2 percent. The variable rate on the swap has an interest rate cap of 15 percent and creates a synthetic variable coupon of BMA plus 0.8 percent, or 2.3 percent as of June 30, 2003. Starting in fiscal year 2009, the notional value of the swap and the principal amount of the associated debt decline.

Fair value. As of June 30, 2003, the swap had a fair value of $9,550,000, calculated using the par-value method: the fixed rate on the swap was compared with the current fixed rates that could be achieved in the marketplace should the swap be unwound. The fixed-rate bond component was valued by discounting the fixed-rate cash flows using the current yield to maturity of a comparable bond. The variable-rate component was assumed to be at par value because the interest rate resets to the market rate at every reset date. The fair value was then calculated by subtracting the established market value of the fixed component from the established market value of the variable component (the par value of the bond).

Credit risk. The swap's fair value represented the authority's credit exposure to the counterparty as of June 30, 2003. Should the counterparty to this transaction fail to perform according to the terms of the swap contract, the authority faced a maximum possible loss equivalent to the swap's $9,550,000 fair value. As of June 30, 2003, the counterparty was rated Aa by Moody's Investors Service and AA by Standard & Poor's and Fitch Ratings. To mitigate credit risk, if the counterparty's credit quality falls below Aa/AA, the fair value of the swap will be fully collateralized by the counterparty with U.S. government securities. Collateral would be posted with a third-party custodian.

Interest rate risk. The swap increases the authority's exposure to variable interest rates. As BMA increases, the city's net payment on the swap increases.

Termination risk. The authority or the counterparty may terminate the swap if the other party fails to perform under the terms of the contract. In addition, the counterparty may terminate the agreement each May 1 and November 1, commencing May 1, 2011. If at the time of termination the swap has a negative fair value, the authority would be liable to the counterparty for that payment.

> The following disclosure should be included in the authority's long-term debt disclosure. It should be appropriately captioned and cross-referenced to the derivative note.

Swap payments and associated debt. Using interest rates as of June 30, 2003, principal and interest requirements of the fixed-rate debt and net swap payments were as follows. As rates vary, net swap payments will vary.

Fiscal Year Ending June 30	Fixed-Rate Bonds		Interest Rate Swaps, Net	Total
	Principal	Interest		
2004	$ —	$12,000,000	$ (5,100,000)	$ 6,900,000
2005	—	12,000,000	(5,100,000)	6,900,000
2006	—	12,000,000	(5,100,000)	6,900,000
2007	—	12,000,000	(5,100,000)	6,900,000
2008	—	12,000,000	(5,100,000)	6,900,000
2009–2013	300,000,000	36,000,000	(15,300,000)	320,700,000
Total	$300,000,000	$96,000,000	$(40,800,000)	$355,200,000

Illustration 4

Swaption

Assumptions

Objective of the swaption. An authority entered into a swaption contract that provided the authority an up-front payment of $10 million. As a synthetic refunding of its 1996 bonds, this payment represents the present-value, risk-adjusted savings of a refunding *as of March 1, 2006,* without issuing refunding bonds at January 2002. The swaption gave the counterparty the option to make the authority enter into a pay-fixed, receive-variable interest rate swap. If the option is exercised, the authority would then expect to issue variable-rate refunding bonds.

Terms. The swaption was entered into in January 2002. The $10 million payment was based on a notional amount of $250 million. The counterparty has the option to exercise the agreement on March 1, 2006—the authority's 1996 bonds' first call date. If the swap is exercised, the swap will also commence on March 1, 2006. The fixed swap rate (5.27 percent) was set at a rate that, when added to an assumption for remarketing and liquidity costs, will approximate the coupons of the "refunded" bonds. The swap's variable payment would be 67 percent of the one-month London Interbank Offered Rate (LIBOR).

Fair value. As of June 30, 2003, the swap had a negative fair value of $8,150,000. Because the terms of the swap at that date were "deep in the money," an option-pricing model such as Black–Scholes was not used to estimate fair value. The zero-coupon method was used instead. This method calculated the future net settlement payments required by the swap, assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments were then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement on the swap.

Risks. Although the underlying swap exposes the authority to credit risk should the swap be executed, the swaption itself does not expose the authority to credit risk. If the option is exercised and refunding bonds are not issued, the 1996 bonds would not be refunded and the authority would make net swap payments as required by the terms of the contract—that is, make a fixed payment to the counterparty for the term of the swap at 5.27 percent and receive a variable payment of 67 percent of LIBOR. If the option is exercised and the variable-rate bonds issued, the actual savings ultimately recognized by the transaction will be affected by the relationship between the interest rate terms of the to-be-issued variable-rate bonds versus the variable payment on the swap (67 percent of LIBOR).

Disclosures

Swaption

Objective of the swaption. The authority entered into a swaption contract that provided the authority an up-front payment of $10 million. As a synthetic refunding of its 1996 bonds, this payment represents the risk-adjusted, present-value savings of a refunding as of March 1, 2006, without issuing refunding bonds at January 2002. The swaption gave the counterparty the option to make the authority enter into a pay-fixed, receive-variable interest rate swap. If the option is exercised, the authority would then expect to issue variable-rate refunding bonds.

Terms. The swaption was entered into in January 2002. The $10 million payment was based on a notional amount of $250 million. The counterparty has the option to exercise the agreement on March 1, 2006—the authority's 1996 bonds' first call date. If the swap is exercised, the swap will also commence March 1, 2006. The fixed swap rate (5.27 percent) was set at a rate that, when added to an assumption for remarketing and liquidity costs, will approximate the coupons of the "refunded" bonds. The swap's variable payment would be 67 percent of the London Interbank Offered Rate (LIBOR).

Fair value. As of June 30, 2003, the swap had a negative fair value of $8,150,000, estimated using the zero-coupon method. This method calculated the future net settlement payments required by the swap, assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments were then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement on the swap.

Market-access risk. If the option is exercised and refunding bonds are not issued, the 1996 bonds would not be refunded and the authority would make net swap payments as required by the terms of the contract—that is, making a fixed payment to the counterparty for the term of the swap at 5.27 percent and receiving a variable payment of 67 percent of LIBOR. If the option is exercised and the variable-rate bonds issued, the actual savings ultimately recognized by the transaction will be affected by the relationship between the interest rate terms of the to-be-issued variable-rate bonds versus the variable payment on the swap (67 percent of LIBOR).

Illustration 5

Commodity Swap

Assumptions

Objective of the swap. A city's power utility is exposed to market price fluctuations on its purchase of fuel oil. The utility uses derivatives—commodity swaps—to protect itself from increases in market prices.

Terms. On January 1, 2003, the utility entered into a commodity swap for a period of three years with semiannual payments. The spot price of fuel oil at that time was $1.00 per gallon. The notional amount is 2 million gallons. Payment between the swap parties is based on the variance between the swap's price of $1.00 per gallon and the then-current spot price as listed by the New York Mer-

cantile Exchange for No. 2 fuel oil. The contract may be cash-settled only; there is no provision for physical delivery of the commodity. At the close of the utility's fiscal year—June 30, 2003—the spot price of fuel oil had declined to $0.95 per gallon. The utility paid the counterparty $100,000 (calculated 2 million gallons × ($1.00 – $0.95)). The change in payment to the counterparty closely matched the cost of fuel oil purchased from the TKP Heating Oil Co.

Fair value. As of June 30, 2003, the commodity swap had a negative fair value of $550,000, estimated by discounting actual or implied forward prices as quoted by the New York Mercantile Exchange for No. 2 fuel oil using the zero-coupon method. The future net settlement payments required by the swap are calculated by assuming that the current forward rates implied by the forward curve for oil prices correctly anticipate future spot prices. Those payments are then discounted using the spot rates implied by the current interest rate yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement of the swap.

Risks. As of June 30, 2003, the utility was not exposed to credit risk because the swap had a negative fair value. However, should implied forward prices increase and the fair value of the swap becomes positive, the utility would be exposed to credit risk on the swap in the amount of its fair value. As of June 30, 2003, the swap counterparty was rated Aa by Moody's Investors Service and AA by Fitch Ratings and Standard & Poor's. To mitigate the potential for credit risk, if the counterparty's credit quality falls below Aa/AA, the fair value of the swap will be fully collateralized by the counterparty with U.S. government securities. Collateral would be posted with a third-party custodian. There are no out-of-the-ordinary termination provisions. However, the utility or the counterparty may terminate the swap if the other party fails to perform under the terms of the contract. Also, if at the time of the termination the swap has a negative fair value, the utility would be liable to the counterparty for a payment equal to the swap's fair value.

Disclosures

Objective of the swap. The city's power utility is exposed to market price fluctuations on its purchase of fuel oil. The utility uses derivatives—commodity swaps—to protect itself from increases in market prices.

Terms. On January 1, 2003, the utility entered into a commodity swap for a period of three years with semiannual payments based on the notional amount of 2 million gallons of No. 2 fuel oil. Payment between the swap parties is based on the then-current spot price.

Fair value. As of June 30, 2003, the commodity swap had a negative fair value of $550,000, estimated by discounting actual or implied forward prices using the zero-coupon method. The future net settlement payments required by the swap are calculated by assuming that the current forward rates implied by the forward curve for oil prices correctly anticipate future spot prices. Those payments are then discounted using the spot rates implied by the current interest rate yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement of the swap.

Credit risk. As of June 30, 2003, the utility was not exposed to credit risk because the swap had a negative fair value. However, should implied forward prices increase and the fair value of the swap becomes positive, the utility would be exposed to credit risk on the swap in the amount of its fair value. As of June 30, 2003, the swap counterparty was rated Aa by Moody's Investors Service and AA by Fitch Ratings and Standard & Poor's. To mitigate the potential for credit risk, if the counterparty's credit quality falls below Aa/AA, the fair value of the swap will be fully collateralized by the counterparty with U.S. government securities. Collateral would be posted with a third-party custodian.

Termination risk. The utility or the counterparty may terminate the swap if the other party fails to perform under the terms of the contract. Also, if at the time of the termination the swap has a negative fair value, the utility would be liable to the counterparty for a payment equal to the swap's fair value.

Appendix 4

CODIFICATION INSTRUCTIONS

31. The section that follows updates the June 30, 2002, *Codification of Governmental Accounting and Financial Reporting Standards: Statement 34 Edition,* for the effects of this Technical Bulletin. Only the paragraph number is listed if the paragraph will be cited in full in the Codification.

* * *

NOTES TO FINANCIAL STATEMENTS **SECTION 2300**

Sources: [Delete GASB Technical Bulletin 94-1 and add the following:] GASB Technical Bulletin 2003-1

[Replace current paragraph .601 as follows:]

TECHNICAL BULLETINS EFFECTIVE AFTER MARCH 15, 1992

Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets

.601 This paragraph provides Technical Bulletin guidance on disclosure requirements for derivatives that are not reported at fair value on the statement of net assets. This paragraph also provides an updated definition of derivatives and disclosure requirements for the objective and terms of the derivative, fair value, and risk exposures. [GASBTB 2003-1, ¶1]

Question 1

Definition

[GASBTB 2003-1, ¶2]

Response

[GASBTB 2003-1, ¶3]

Question 2

Derivative Disclosures

[GASBTB 2003-1, ¶4]

Response

[GASBTB 2003-1, ¶5–¶10; update cross-references]

Question 3

Determination of Fair Value

[GASBTB 2003-1, ¶11]

Response

[GASBTB 2003-1, ¶12; update cross-references]

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